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Supreme Court of the United States

OCTOBER TERM, 1935.

No. 743.

FRANK O. LOWDEN, JAMES E. GORMAN AND JOSEPH B. FLEMING, AS TRUSTEES OF THE ESTATE OF THE CHICAGO, ROCK ISLAND AND PACIFIC RAILWAY COMPANY,

Appellants Below,

vs.

NORTHWESTERN NATIONAL BANK AND TRUST COMPANY OF MINNEAPOLIS, MINNESOTA, FORMERLY THE NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS, MINNESOTA,

Appellee Below.

ON CERTIFICATE FROM THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

BRIEF AND ARGUMENT FOR APPELLEE BELOW.

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OPINION BELOW.

The opinion of the District Court below was filed June 17, 1935. It is reported as *Lowden, et al., vs. Northwestern National Bank and Trust Company of Minneapolis,* in 11 Fed. Suppl. 929 (D. C., Minn.). The Circuit Court of Appeals has filed no opinion, reserving decision pending the opinion of this Court upon the questions certified.

JURISDICTION.

The Circuit Court of Appeals has certified three questions of law to this Court for instructions. Jurisdiction of this Court rests upon the certificate so made, pursuant to Section 239 of the Judicial Code, as amended (28 U. S. C. A., §346).

QUESTIONS PRESENTED.

The questions here presented are those certified as follows:

Question 1. Does the right of set-off recognized by Section 68 (a) of the Bankruptcy Act apply to reorganization proceedings under Section 77 of that Act?

Question 2. If the first question be answered in the affirmative, can a bank which owns the unmatured bonds of a railroad corporation set off a deposit account of the railroad with the bank against the bonds, upon the filing by the railroad of a petition for reorganization under Section 77 of the Bankruptcy Act, alleging that the railroad is unable to meet its debts as they mature?

Question 3. If the first and second questions be answered in the affirmative, may the United States District Court for the District of Minnesota, in the suit by the trustees of the railroad's estate to recover the amount deducted from the account of the railroad by the bank under the claimed right of set-off, recognize and establish as a proper set-off by the bank one which was not made until after the filing of the petition for reorganization and which has never been ordered, authorized, approved, or consented to by the court in which that petition was filed and approved?

STATUTES INVOLVED.

The statutes directly involved are §77 of the Bankruptcy Act (as adopted March 3, 1933), 11 U. S. C. A., §205; and §68 of the Bankruptcy Act., 11 U. S. C. A., §108.

Section 77 is set forth in full as an appendix to appellants' brief. Accordingly, it is here omitted.

Section 68 reads as follows:

> "(a) In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid.
>
> (b) A set-off or counterclaim shall not be allowed in favor of any debtor of the bankrupt which (1) is not provable against the estate; or (2) was purchased by or transferred to him after the filing of the petition, or within four months before such filing, with a view to such use and with knowledge or notice that such bankrupt was insolvent, or had committed an act of bankruptcy."

STATEMENT OF CASE.

A statement of the case is here omitted. It is found at pages 1-3 of the certificate and at pages 2-4 of appellants' brief.

SUMMARY OF ARGUMENT.

I.

Certain underlying principles. In the consideration of the three certified questions, certain aspects of the set-off right should be kept in mind:

A. It is not a mere matter of procedural remedy but a substantive right in the nature of a possessory lien,

favorably regarded and liberally treated by the courts.

B. The right comes into existence when the relationship of mutual debtors arises, though its exercise or enforcement may be dependent upon the subsequent occurrence of certain conditions.

II.

Question 1. Does the right of set-off recognized by Section 68 (a) of the Bankruptcy Act apply to reorganization proceedings under Section 77 of that Act?

This question should be answered in the affirmative:

A. Under provisions of the Bankruptcy Act antedating §77, the title of the debtor passing to the trustee has long been subject to valid liens, including the set-off right.

B. A proper construction of §77 requires the conclusion that the substantive set-off right was not thereby abrogated:

1. The exercise of the set-off right under §68 (a) is "consistent with the provisions" of §77 and hence affirmatively preserved by subdivision (n) of §77 (App. Br., p. 54).

2. The contended contrary construction rests upon implication alone, which is an inadequate basis to establish an intended repeal of §68 (a) or an intended abrogation of the long-established policy of recognition of the equitable set-off right, and of all substantive lien rights in bankruptcy proceedings.

3. Subd. (g), subd. par. 6 (App. Br., p. 50), re-

quiring adequate protection of creditors' "securities, liens and claims" and subdivisions (d) and (g) (sub. par. 1), prohibiting discrimination against any creditors, necessarily contemplate preservation of the substantive set-off "lien" in common with all other liens.

4. Such a contrary construction would present reasonable and serious doubts as to constitutionality.

C. If §77 be construed as intending or providing abrogation of the set-off right, it is, to that extent, unconstitutional, as violating the Fifth Amendment.

III.

Question 2. If the first question be answered in the affirmative, can a bank which owns the unmatured bonds of a railroad corporation set off a deposit account of the railroad with the bank against the bonds, upon the filing by the railroad of a petition for reorganization under Section 77 of the Bankruptcy Act, alleging that the railroad is unable to meet its debts as they mature?

This question should be answered in the affirmative because:

A. Neither insolvency nor maturity of the debt is essential to the exercise of the set-off right under §68.

1. Insolvency is not an essential because

(a) It is not a prerequisite to bankruptcy proceedings even under the general provisions of the Act.

(b) Section 68 provides for set-off in *all* cases

arising under the Act, except as limited by subdivision (b).

2. A debt not matured is nevertheless provable and hence may be set off.

B. If the right depended in the alternative upon maturity of the debt or non-maturity plus insolvency, the right exists under the facts stated or permissively to be assumed under Question 2.

1. Any possible requisite of maturity is eliminated because the question assumes insolvency within the equity concept.

2. Any possible requisite of insolvency is eliminated because the facts stated or which may be assumed under Question 2 require that the bonds be regarded as matured:

(a) As initiation of general proceedings "matures" a debt, so the filing of a petition under §77 declaring inability to pay the very bonds in question requires that they be treated as matured.

(b) Their actual maturity and default prior to the trustees' suit and its trial required the court below to determine the equities as then existing.

IV.

Question 3. If the first and second questions be answered in the affirmative, may the United States District Court, for the District of Minnesota, in the suit by the trustees of the railroad's estate to recover the amount deducted from the account of the railroad by

the bank under the claimed right of set-off, recognize and establish as a proper set-off by the bank one which was not made until after the filing of the petition for reorganization and which has never been ordered, authorized, approved, or consented to by the court in which that petition was filed and approved.

A. This question should be answered in the affirmative:

1. In proceedings under the general provisions of the Bankruptcy Act, such set-off right is recognized and enforced in such a plenary action by the trustees outside the territorial limits of the bankruptcy court, under the following principles determining its jurisdiction:

   (a) The jurisdiction of the bankruptcy court is an administrative jurisdiction exercisable by summary proceedings and extending and confined to the debtor and his property within the actual or constructive possession of the court.

   (b) In exercising that jurisdiction, the bankruptcy court cannot issue process either *in rem* or *in personam* beyond its territorial limits, but must resort to ancillary administration.

   (c) The bankruptcy court has no jurisdiction over controversies between the trustee and third parties as to debts owed or property adversely possessed and claimed by third parties (with exceptions here immaterial); such controversies must be determined in plenary actions by the trustee in other courts.

(d) Accordingly, it has long been established that such set-off is to be recognized in a plenary action by a trustee in another court; and this even though the claim so set off has not been proved in the bankruptcy court.

2. Whatever enlarged jurisdiction is deemed conferred by §77, the provisions of that amendment should not be construed as preventing recognition of set-off in a plenary action properly instituted by the trustees in another court:

(a) Cogent reasons sustain a construction of §77 as extending administrative jurisdiction exercisable by summary proceedings beyond the territorial limits of the court, thereby dispensing with the necessity for ancillary administration.

(b) Cogent reasons preclude construction of §77 as creating plenary jurisdiction to adjudicate controversies concerning debts owed the estate, or property adversely possessed and claimed, by third parties beyond the territorial jurisdiction; therefore, the Minnesota Court had jurisdiction to entertain the trustees' suit and determine the set-off right therein.

(c) Even if §77 were to be construed as vesting such plenary jurisdiction in the bankruptcy court, the latter court may consent to the exercise of such jurisdiction by other competent courts; and here, such consent should be assumed from the fact

of the trustees' invoking of the jurisdiction of the Minnesota District Court.

B. A negative answer could only rest upon a view that §77 vests unlimited plenary jurisdiction *exclusively* in the bankruptcy court, rendering any proceedings in the Minnesota court a nullity and requiring dismissal of the trustees' suit below. Such an answer, if reached, should be so explained or qualified as to avoid an improper result of sustaining the trustees' suit while denying the set-off.

ARGUMENT.

I.

Certain Underlying Principles.

There are certain characteristics of the set-off right which have an important bearing upon some of the contentions hereinafter discussed. Wholly aside from them, we believe the three questions each require an affirmative answer. However, certain fundamental concepts as to the nature of the right furnish additional reasons making that conclusion imperative.

A. The Right Is in the Nature of a Substantive Lien to Be Favorably Regarded and Treated.

The set-off right is not a mere matter of procedural remedy but *a substantive right in the nature of a possessory lien.* It is a right long established, recognized and favored by courts of equity. Section 68 (a) of the Bankruptcy Act did not create the right but provided for its recognition and enforcement in bankruptcy proceedings.

In *Studley vs. Boylston National Bank*, 229 U. S. 523, this court, in sustaining the right in bankruptcy proceedings, said:

"That section did not create the right of set-off, but recognized its existence, and provided a method by which it could be enforced even after bankruptcy. What the old books called a right of stoppage—what business men call set-off—is a right given or recognized by the commercial law of each of the states, and is protected by the bankruptcy act if the petition is filed before the parties have themselves given checks, charged notes, made book entries, or stated an account whereby the smaller obligation is applied on the larger.

The banker's lien on deposits, the right of retention and set-off of mutual debts, are frequently spoken of as though they were synonymous, while in strictness, a set-off is a counterclaim which the defendant may interpose by way of cross-action against the plaintiff. But, broadly speaking, it represents the right which one party has against another to use his claim in full or partial satisfaction of what he owes to the other. That right is constantly exercised by business men in making book entries whereby one mutual debt is applied against another."

In *Carr vs. Hamilton*, 129 U. S. 252, the court said:

"Natural justice and equity would seem to dictate that the demands of parties mutually indebted should be set off against each other, and that the balance only should be considered as due. But the common law, for simplicity of procedure, determined otherwise, and held that each claim must be prosecuted separately. 'The natural sense of mankind,' says Lord Mansfield, 'was first shocked at this in the case of bankrupts; and it

was provided for by 4 Anne, c. 17, §11, and 5 Geo. II, c. 30, §28.' *Green vs. Farmer,* 4 Burr, 2220, cited in 2 *Story, Eq. Jur.,* §1433. In pursuance of these old statutes, and of the dictates of equity, the principle of set-off between mutual debts and credits has for nearly two centuries past been adopted in the English Bankrupt Laws, and has always prevailed in our own whenever we have had such a law in force on our statute book; and it mattered not whether the debt was due at the time of bankruptcy or not."

In *The Gloria, etc.,* 286 Fed. 188, upon the express theory that the right of set-off is not "regarded as a mere matter of procedure" but as "affecting the substantive rights of the litigants," the court held that it should be established and enforced against the claims of sovereign states, stating that

> "Once the state has chosen its forum, there seems little reason in law or policy why it should not be subject to the substantive requirements of law and justice."

Upon certification by the Circuit Court of Appeals for the Second Circuit, as to whether the District Court had power to enter such a decree, this court, under the title *Luckenbach S. S. Co. vs. Norwegian Barque,* 266 U. S. 328, answered in the affirmative, stating that

> "the reasons are strong for not obstructing the application of natural justice against the government by technical formulas when justice can be done without endangering any public interest."

In *Central Appalachian Co. vs. Buchanan,* 90 Fed. 454 (6 C. C. A., before Taft and Lurton, Circuit Judges, and Clark, District Judge), in an extensive discussion of the set-off right, the court said:

> "So, courts of equity of the United States have been

peculiarly alert to prevent the defeat of an equitable right of set-off by the interposition of assignments, receiverships or statutory liquidations, and to extend the right whenever there appeared any substantial equity in favor of the claim."

In *First Nat'l Bank vs. Malone*, 76 Fed. (2d) 251 (8 C. C. A.), the court, discussing the equitable origin and nature of set-off and its accomplishment of justice, said:

"While the doctrine was originally 'a mere procedural convenience, it has now become 'really a requirement of substantive justice.'"

In *Wisdom vs. Guess Drycleaning Co.*, 5 Fed. Suppl. 762 (Dist. Mass.), after an extensive discussion of the set-off right, the court said:

"We have seen that the better modern view regards set-off as a substantive right."

The right has been characterized as in the nature of a lien, by this court and others. *Central Nat'l Bank vs. Connecticut, etc., Co.*, 104 U. S. 54; *Goodwin vs. Barre Savings, etc., Co.*, 91 Vt. 286; *Andrew vs. American Savings Bank*, 218 Iowa 489; see, also, *Champlin Refining Co. vs. Gasoline Products Co.*, 29 Fed. (2d) 331, 338 (1 C. C. A.); *In re W. & A. Bacon Co.*, 261 Fed. 109, 111 (Dist. Mass.).

In its essence, set-off is the right of A to withhold payment of his debt to B and to apply it, *pro tanto*, upon B's debt to him. Its nature is such that if A is compelled to pay his debt to B, the set-off right is gone, and he then has only his wholly unsecured claim against B. *In short, the denial or staying of its exercise, when B sues A, is necessarily a complete destruction of the right.* This characteristic should be clearly kept in mind in the consideration of the questions here certified.

B. THE RIGHT ARISES AND EXISTS CONCURRENTLY WITH THE INCEPTION AND CONTINUANCE OF THE RELATIONSHIP OF MUTUAL DEBTORS, THOUGH ITS ENFORCEMENT MAY BE SUBJECT TO CERTAIN CONDITIONS.

It seems quite evident that the set-off right accrues when mutuality of debts arises though it may not be enforcible until certain conditions later occur. The creation of the contractual relationship in case of a pledge or mortgage gives rise to the lien, though it is not enforcible until default. The conditioning of the right to foreclose or enforce either a contractual or a set-off lien upon certain events does not negative, but rather presupposes its prior existence.

These conclusions are implicit in the decision in *North Chicago Rolling Mill Co. vs. St. Louis Ore & Steel Co.*, 152 U. S. 596. In that case, A had sued B and garnisheed C. At the time of garnishment there existed a contract between B and C. Subsequently, C sued A to restrain A from enforcing the garnishment until damages claimed by C from B under that contract had been ascertained and set off against C's debt to B. This court sustained C's right to such injunction as against a claim by A that the right of set-off had not arisen until after the garnishment. This court said in part:

> "The material thing is that the contract (for the breach of which the claim for damages arises) was in existence when the garnishment process was served."

And again:

> "It is sought to defeat this right of the Chicago Company by invoking in favor of the Joliet Company, and its assignee, Ferguson, the doctrine of relation so as to antedate the claim for damages. This cannot be done

for two reasons: first, because the breach of contract, on which the claim for damages is based, had in fact commenced before the garnishment writ was served; second, if that had not been the case, the contract, for the non-performance of which the right for damages arises, was in existence when the garnishment proceedings were instituted.

This unquestioned fact is very material, if not controlling of the case. The court below did not give the fact that the claim for damages arose under and by virtue of a contract in existence prior to the date of the attachment its due weight and importance as will be seen by a brief reference to the authorities bearing upon the question."

Citing with approval state court decisions reaching a like conclusion, the court spoke of one as "allowing a set-off which matured after action brought," and said:

"In other words, the principle established by these cases is that whatever rights the garnishee may have under existing contracts with the principal debtor, he is entitled to have the benefit thereof as against the attaching creditor."

As hereinafter observed, Questions 1 and 2 are broad enough to permit assumption of facts found below establishing that the existence of the deposit account and the bank's ownership of the bonds antedated not only the filing of the petition under §77 but also the enactment of that statute. The materiality of such a permissive hypothesis upon certain contentions will be later discussed.

II.

Question 1. The Right of Set-Off Recognized by Section 68 (a) of the Bankruptcy Act Should Be Held to Apply to Reorganization Proceedings Under §77 of That Act.

A. Under Provisions of the Bankruptcy Act Antedating §77, the Title of the Debtor, Passing to the Trustee, Has Long Been Subject to Valid Liens, Including the Right of Set-Off.

Certain provisions of the Bankruptcy Act, and their sequence, should be noted.

Section 67 provides:

"(a) Claims which for want of record or for other reasons would not have been valid liens as against the claims of the creditors of the bankrupt shall not be liens against his estate.

* * * * * * * * *

(d) Liens given or accepted in good faith and not in contemplation of or in fraud upon the provisions of this title, and for a present consideration, which have been recorded according to law, if record thereof was necessary in order to impart notice, shall, to the extent of such present consideration only, not be affected by anything herein."

Section 68 provides:

"Set-offs and counterclaims. (a) In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and

one debt shall be set off against the other, and the balance only shall be allowed or paid.

(b) A set-off or counterclaim shall not be allowed in favor of any debtor of the bankrupt which (1) is not provable against the estate; or (2) was purchased by or transferred to him after the filing of the petition, or within four months before such filing, with a view to such use and with knowledge or notice that such bankrupt was insolvent, or had committed an act of bankruptcy."

Section 70 provides:

"(a) The trustee of the estate of a bankrupt, upon his appointment and qualification, and his successor or successors, if he shall have one or more, upon his or their appointment and qualification, shall in turn be vested by operation of law with the title of the bankrupt, as of the date he was adjudged a bankrupt, except in so far as it is to property which is exempt."

Under these sections, it has uniformly been held that the trustee's title is subject to all valid liens and equities of creditors or other parties. This principle is not affected by the amendment of June 25, 1910, c. 412, §8, vesting the trustee with the rights, remedies and powers of a judgment creditor holding an unsatisfied execution, for the rights of such a creditor are necessarily subordinate to valid liens and equities of third persons. The principle applies not only in cases of bankruptcy but in receiverships and like proceedings. Cases expressly recognizing the principle, include the following: *In re Searles,* 200 Fed. 893 (E. D., N. Y.) (bankruptcy proceedings); *Scott vs. Armstrong,* 146 U. S. 499 (liquidation of national bank); *Central Appalachian Co. vs. Buchanan,* 90 Fed. 454 (6 C. C. A.) (equity receivership).

The principle is necessarily recognized in the numerous decisions which have uniformly sustained the right of set-off in actions brought by trustees against debtor-creditors. 4 *Remington on Bankruptcy,* 4th Ed., §1451, at p. 217, and §1473, p. 249. It would require no discussion here except for the assumption of appellants that recognition and enforcement of the set-off right under §77 would be equivalent to a withdrawal, *pro tanto,* of property available for reorganization plans (App. Br., pp. 13, 15, 17). This assumption is erroneous unless it be assumed that as to set-off, at least, §77 departs from the long established bankruptcy concept that, as to secured creditors, all that passes to the bankruptcy estate is the debtor's equity. That assumption is the very point at issue. At the time of the filing of the petition, the railroad did not have an absolute right to the deposit account. The account was subject to the possessory set-off lien. Upon or after the filing of the petition, no absolute right to the account became vested in the railroad's estate, or the subsequently appointed trustees, unless §77 be construed as abrogating the set-off right upon such event and unless, as so construed, such provision is valid. Therefore, to say that §77 should be so construed because the exercise of the set-off right would withdraw assets otherwise vested in the bankruptcy estate leads nowhere. The immediate question is simply whether §77 is to be construed as vesting in the estate an absolute title free from the set-off lien to which it would remain subject in proceedings under the general provisions of the Act.

B. A Proper Construction of §77 Requires the Conclusion That the Substantive Right of Set-Off Was Not Thereby Abrogated.

This conclusion was reached by the District Court below, 11 Fed. Suppl. 929; likewise, by the District Court for Iowa in an action by the same trustees, *Lowden, et al., vs. Iowa-Des Moines National Bank,* 10 Fed. Suppl. 430. A like conclusion was reached by the District Court for the Southern District of New York, under §77B and subdivision (k) thereof, in *Re Associated Telephone Utilities Co.,* 12 Fed. Suppl. 468. For the reasons next herein discussed, we submit that the conclusions of these courts are correct and that the contrary construction here urged cannot be sustained.

1. *The exercise of the set-off right is consistent with the provisions of §77 and hence affirmatively preserved by subdivision (n) thereof.*

Subsequent contentions aside, it would seem that subdivision (n) of §77 is alone decisive as to the point involved. That subdivision provides:

> "In proceedings under this section and consistent with the provisions thereof, the jurisdiction and powers of the court, the duties of the debtor and the rights and liabilities of creditors, and of all persons with respect to the debtor and his property, shall be the same as if a voluntary petition for adjudication had been filed and a decree of adjudication had been entered on the day when the debtor's petition was filed."

Unless preservation of the set-off is inconsistent with *the provisions* of §77, it is not thereby abrogated.

There is no provision in §77 denying the set-off right or

even mentioning it. There is nothing providing for destruction of substantive rights or liens of creditors of any class. The preservation of that right presents no inconsistency or repugnancy, inherent or otherwise, with any of the actual provisions of §77. A construction preserving the set-off right under subdivision (n) does not nullify any other express provision of the section.

There are certain suggestions of inconsistency of §68 with specified provisions of §77, briefly stated at pages 15-18 of appellants' brief.

It is there said that the allowance of the set-off right by the bank would give it a "preference" over other holders of the same issue of bonds, that a preference is generally denounced by §77 and that subdivisions (c) to (g), inclusive, require like treatment of all creditors. The assumption of a preference is clearly fallacious. A similar argument that allowance of set-off is bankruptcy or like proceedings has twice been clearly rejected by this court. In *New York County Bank vs. Massey*, 192 U. S. 138, this court, in sustaining the set-off right under §68, said:

> "It is true that it creates a debt, which, if the creditor may set it off under §68, amounts to permitting a creditor of that class to obtain more from the bankrupt's estate than creditors who are not in the same situation, and do not hold any debts of the bankrupt subject to set-off. But this does not, in our opinion, operate to enlarge the scope of the statute defining preferences so as to prevent set-off in cases coming within the terms of §68a. If this argument were to prevail, it would, in cases of insolvency, defeat the right of set-off recognized and enforced in the law, as every creditor of the bankrupt holding a claim against the estate subject to reduction to the full amount of a debt due the bankrupt re-

ceives a preference in the fact that, to the extent of the set-off, he is paid in full."

In *Scott vs. Armstrong,* 146 U. S. 499, in sustaining a set-off in a national bank liquidation, this court said:

> "Where a set-off is otherwise valid, it is not perceived how its allowance can be considered a preference, and it is clear that it is only the balance, if any, after the set-off is deducted which can justly be held to form part of the assets of the insolvent. The requirement as to ratable dividends, is to make them from what belongs to the bank, and that which at the time of the insolvency belongs of right to the debtor does not belong to the bank."

It is just as clear that allowance of the set-off under the facts here certified would not constitute a preference as to other holders of the railroad's bonds. The mere fact that the bank, unlike other bondholders, has by other transactions wholly unrelated to the trust indenture, acquired an additional security in the nature of a set-off right, in no way makes the exercise of that right a preference over other bondholders. Accordingly, the above mentioned suggestion of inconsistency of §68 with §77 is wholly groundless.

Appellants also state that §68 is inconsistent with subdivision (j) of §77 because the latter provides that upon confirmation of a reorganization plan "the property of the debtor" shall be free from all claims, etc. (App. Br., p. 17). As a matter of fact, subdivision (j) refers to the "property dealt with by the plan." If §77 does not abrogate the set-off right, then the bank account, so far as subject thereto, is not property to be "dealt with by the plan"; it belongs to the one possessed of the set-off right. In *Scott vs. Armstrong, supra* (hereinafter noted at more length), in answering a like contention that provisions in the act for

liquidating insolvent national banks, as to ratable distribution of assets of the bank, precluded the right of set-off against such assets, this court held that the distribution of dividends were to be made only

> "from what belongs to the bank and that which at the time of insolvency belongs of right to the debtor does not belong to the bank."

Hence, just as in that case the assets of the insolvent bank available for ratable dividend distribution could not include assets belonging to others under the set-off right, so here, the property to be dealt with on reorganization cannot include assets belonging to others under the set-off right, unless §77 be construed as destroying that right. Again, that is the very point here at issue. Subdivision (j) of §77 does not attempt to state what property shall be dealt with by the plan. It does not say that choses in action upon which a debtor-creditor has a possessory or analogous lien shall be dealt with free from that lien. It is patent that said subdivision is not inconsistent with §68. It is not nullified by the exercise of the set-off right under §68. It operates, as previous provisions of bankruptcy or insolvency acts concerning administration of assets have operated, only upon the titles or equities otherwise vested in the bankrupt or insolvent estate, or its trustees.

It is clear, therefore, that it cannot be concluded that the set-off right is denied by §77 because its exercise would be inconsistent with any actual provisions of the act. Nowhere does the act provide for its denial. No provision is nullified by its exercise. The essence of appellants' argument is that §68 is inconsistent, not with the provisions, but with the purposes of §77 (App. Br., pp. 5-6, 8-16, etc.). That will be shortly discussed. But, immediately, we insist that *in the absence of inconsistency of §68 with actual provisions*

of §77, subdivision (n) of the latter is controlling. As Judge Nordbye, below, said:

> "But we are confronted with the unambiguous language contained in subsection (n) of Section 77 to the effect that the rights and liabilities of creditors with respect to the debtor and his property shall be the same as if a voluntary petition had been filed and the debtor adjudicated a bankrupt. It is fair to assume that, in so far as it may be consonant with the general provisions of Section 77, Congress intended by subsection (n) to fix the status of the parties as to their rights and liabilities with reference to liens, preferences, etc., as would have resulted in the event there had been an adjudication." (11 Fed. Suppl. 929, at 935.)

And again:

> "A deposit in a bank under the circumstances herein simply creates an ordinary debt. If there is no inconsistency between the right of set-off and the provisions of Section 77, and if subsection (n) is to be construed literally, it seems reasonably clear that the rights of the bank on June 7th are to be determined in the same way as if the Rock Island had been adjudicated a voluntary bankrupt." (11 Fed. Suppl. 929, at 936.)

In the Iowa case between the same trustees and the Des Moines bank, Judge Dewey said:

> "Section 77 expressly provides that provisions of the general Bankruptcy Act which are consistent with the provisions of Section 77 shall control the rights and liabilities of the creditors; and Section 68 of the Bankruptcy Act expressly permits set-offs and counterclaims. In the absence of any provision in Section 77 limiting this right of set-off, I can see no reason why creditors are not entitled to the same rights with respect to set-

off of mutual debts and credits as they would have had the Railway Company invoked the general bankruptcy laws." (10 Fed. Suppl. 430, at 432.)

2. *The contended contrary construction rests upon the inadequate basis of implication from an assumption of the general purposes of* §77.

In the light of the affirmative provisions of subdivision (n), we do not concede that discussion or conjecture as to whether abrogation of the set-off right under §68 was one of the purposes or intended effects of §77, is in order. If the Congress had intended to abrogate, it could, and should have expressly so provided. If it had intended to overthrow any substantive right so long established and so favorably recognized and extended by courts of equity, it should have so declared in plain terms. If it had intended to enact such a radical departure from the policy of bankruptcy statutes as to legislate out of existence, established lien or security rights, such intent should not have been left to speculative implication.

The historic prevalence of the right in bankruptcy legislation is emphatically noted in *Carr vs. Hamilton,* 129 U. S. 252. The historic policy of American bankruptcy legislation in avoiding actual impairment of valid liens or substantive rights is emphasized in *Louisville Joint Stock Land Bank vs. Radford,* 295 U. S. 555, at 583, 589. It is a cardinal rule of construction that neither firmly established principles of law nor long recognized legislative policy is to be abrogated by mere implication of such intended purpose or result. *Robertson vs. Railroad Labor Board,* 268 U. S. 619; *Panama R. R. Co. vs. Johnson,* 264 U. S. 375.

In the absence of provisions expressing such intent, coun-

sel, of necessity, have been remitted to the contention that the set-off right is not consistent with the "purposes" of §77; hence its intended abrogation must be implied. Discussion is unnecessary to emphasize that whether we talk of contracts or of statutes, there is a wide difference in fact and in law between actual provisions, on the one hand, and purposes, whether recognizable or arguable, on the other. Parties to a contract, or legislative bodies, may have a purpose, even clearly beyond dispute, but they may omit to make the actual provisions necessary to give effect thereto. Here, the claim as to purpose is purely nebulous. No one can assert that Congress intended specifically to abrogate the set-off right. It is simply argued that because of certain declared purposes as to permitting reorganizations, it must be further speculated that Congress must have intended to abrogate a specific and long-established right although it made no provision for its abrogation. By what concept of construction it is claimed such an undeclared and unestablished "purpose" can, by implication, override the express terms of subdivision (n) is not even suggested. The decision of this court in *Scott vs. Armstrong, supra,* rejecting a like contention that the set-off right was impliedly abrogated by the Acts of Congress providing for the method of liquidation of insolvent national banks seems to us conclusive here. In an attempt therein to defeat the exercise of the set-off right it was argued that certain provisions of the act there involved contemplated ratable distribution of assets among all creditors. In rejecting the contention the court said:

> "The argument is that these sections by implication forbid this set-off because they require that after the redemption of the circulating notes has been fully provided for, the assets shall be ratably distributed among

the creditors, and that no preferences given or suffered, in contemplation of or after committing the act of insolvency, shall stand. And it is insisted that the assets of the bank existing at the time of the act of insolvency include all its property without regard to any existing liens thereon or set-offs thereto.

We do not regard this position as tenable. * * * liens, equities, or rights arising by express agreement, or implied from the nature of the dealings between the parties, or by operation of law, prior to insolvency and not in contemplation thereof, are not invalidated. The provisions of the Act are not directed against all liens, securities, pledges, or equities, whereby one creditor may obtain a greater payment than another, but against those given or arising after or in contemplation of insolvency."

Referring to the long established recognition of set-off in the English Bankruptcy Acts, the court continued:

"The succeeding statutes were but in recognition, in bankruptcy and otherwise, of the practice in chancery in the settlement of estates, and it may be said that in the distribution of the assets of insolvents under voluntary or statutory trusts for creditors the set-off of debts due has been universally conceded. The equity of equality among creditors is either found inapplicable to such set-offs or yields to their superior equity.

"We are dealing in this case with an equitable set-off, but if on June 20th the note had matured and each party had a cause of action capable of enforcement by suit at once, upon the argument for the receiver the legal set-off would be destroyed just as effectually as it is contended the equitable set-off is. *We cannot believe Congress intended such a result, or to destroy by*

implication any right vested at the time of the suspension of a national bank." (Italics ours.)

It therefore seems to us that appellants' argument that an intent to abrogate the set-off right should be implied because its exercise might, in certain assumed instances, hamper the accomplishment of a reorganization plan, merits no discussion. However, we shall briefly examine it. Reduced to its essence, the argument is that *if* a given railroad had all or the bulk of its working capital on deposit in banks, and *if,* in turn, these several banks happened to own the railroad's bonds in amounts aggregating all or a large part of such deposits, allowance of the set-off right rendering such funds unavailable for operation or reorganization *might prevent* the accomplishment of any reorganization as contemplated by §77. In an attempt to illustrate those hypotheses, counsel step outside the record (App. Br., p. 13). Even then, it is noteworthy that there is no assertion that the fifty Rock Island bank depositaries held bonds which might be a basis for set-off. It must be quite patent that the situations wherein there would be mutuality of debts as between carriers and others would be rare. If the dangers had actually been as great and fearful as here urged by counsel, and if Congress had so thought and had intended to avert them, there can be little doubt that clear and specific provisions against that result would have been made. It may not be amiss to note, in passing, that such right had been exercised by two of the banks involved in the main Rock Island case, *Continental Ill. Nat. Bank vs. C., R. I. & P. Co.,* 294 U. S. 648; yet no one indicated any of the apprehension here voiced by counsel. In note 2 at page 659, a tabulation is given showing that the total loans of the five banks whose sale of collateral was enjoined amounted to $4,125,000.00. The note further states that:

"The $4,125,000.00 was reduced to $3,866,923.34 by application of debtors' deposits in the Continental and Mississippi Valley Banks."

Yet the assumption of counsel and the Court seems clearly to have been that a plan of reorganization would be successfully worked out. The calamity argument here urged not only assumes that the contended construction can be reached by implication, but also presupposes a real and general hazard, its recognition by Congress, and an intent to avert it. Upon the record, none of these assumptions has any factual or legal basis. The record contains no facts establishing the hazard. Nothing indicates its recognition by Congress. The act contains no express provisions evidencing the assumed intent.

We may go a step further. In the *Continental Bank case,* 294 U. S. 648, it appeared that securities aggregating $200,000,000.00 belonging to the Rock Island (294 U. S., at 678) were pledged to various creditors. Such securities, if discharged of the pledge liens, would have constituted assets of the railroad and a source of funds available for operation and for consummation of a reorganization plan. While this court held that a sale of such securities by the pledgees might temporarily be stayed, it did not hold nor has it been claimed that §77 abrogated or was intended to abrogate the substantive security right of such pledgees. Yet the same arguments advanced by appellants for implied abrogation of the right of set-off apply with equal force to other security rights. Even upon the erroneous assumptions involved in appellants' hypothesis there is no more reason for implying, as to §77, a repeal or nullification of §68 preserving that set-off right in bankruptcy, than there is for implying a repeal or nullification of §67 (d) preserving other valid lien rights. And in the *Continental Bank case,* this

court clearly implied the continuing application of §67 (d) in proceedings under §77, saying:

> "The injunction does not infringe §67 (d), U. S. C. Title 11, §107 (d)." (294 U. S., at 676.)

Upon what basis can it be inferred that Congress intended to discriminate? Wherein lies the foundation for the contention that Congress intended to carry forward into §77 the protection of liens under §67 (d) but to withhold the protection of the set-off right under §68? None of the gratuitous hypotheses advanced suggest any basis for such arbitrary discrimination.

Appellants invoke a decision of the same court which certified the questions here presented—*Grand Boulevard Investment Co. vs. Strauss,* 78 Fed. (2d) 180 (App. Br., pp. 21-2). It is claimed that the decision therein requires the conclusion that the possessory lien or set-off is not preserved by §77. Obviously, the Eighth Circuit Court did not consider its decision therein as requiring such conclusion; otherwise it would hardly have certified Question 1 here. That opinion merely decided that the discretionary power under §77B to suspend remedial rights included the power to require a mortgagee in possession to surrender possession. The mortgagee's right of possession was merely one of its remedial rights. The decision relied upon, but went no further than the decision of this court in the *Continental Bank case.* Neither case involved or inferentially sanctioned any abrogation or destruction of the substantive security right. On the contrary, both decisions carefully noted that the substantive rights of the lien holder were not impaired. Appellants' attempted comparison by reason of the fact that in the case here certified the bank was in possession (as was the mortgagee in the *Grand Boulevard case)* wholly fails, because *as to the possessory lien of set-*

off, a required surrender of possession necessarily destroys the lien.

We submit that in the absence of express provision to the contrary, not only is the right of set-off clearly preserved by subdivision (n) of §77 but also that the claim of its abrogation cannot be sustained upon the resort to implication.

3. *Other provisions of §77 require the conclusion that there was no intent to abrogate the set-off right.*

Appellants have noted the provisions of subdivisions (c) to (g), inclusive, of §77. We have already discussed their contention that allowance of set-off would constitute a preference contrary to the intent of these provisions. A further consideration of these provisions leads to the conclusion that rejection of the set-off right would violate these very provisions.

It is clearly a fundamental concept of §77 that creditors shall be classified and that all in a given class shall be treated fairly and without discrimination. It is just as clear that appellants' contention would flatly violate this concept by totally destroying a security right otherwise possessed by defendant.

Briefly summarized, subdivisions (c) to (g-1) contemplate a division of creditors into appropriate classes and forbid discrimination as between them. Sub-paragraph 6 of subdivision (g) further requires that any reorganization plan must provide

> "adequate protection for the realization by them of the value of their securities, liens and claims."

Under the authorities heretofore noted, a creditor possessed of a set-off right is not an unsecured creditor. His

is a security right—more valuable and efficient than a lien evidenced by a mortgage or pledge because no legal machinery and no delay is involved in its enforcement. *Its nature is such that if its recognition is denied when the creditor is sued by the trustee, the right is totally destroyed.* To be sure, the creditor's claim may persist, but only as an unsecured claim; the security right, however, is gone. This was recognized by Judge Nordbye, below:

> "If this Court should now deny the defendant the right of set-off and require the bank to turn over this deposit to the trustees, the bank would be left in a position whereby it could never exercise its right of offset in the reorganization proceeding."
>
> (11 Fed. Suppl. 929, at 935.)

While the *Continental Bank case* holds that proceedings to enforce pledges may be temporarily suspended under §77, the opinion of this court makes it clear that the substantive lien right cannot be destroyed. 294 U. S. at 677-8, 681. Are we then to say that, of necessity, the substantive set-off right must be destroyed—that such was the intent of §77? The provisions cited clearly indicate the contrary. "Adequate protection for the realization by them (creditors) of the value of their securities, liens and claims" is just as much of the essence and spirit of §77 as the accomplishment of a reorganization. No one can say that §77 contemplates that the sole aim and purpose of §77 is a successful reorganization, to be accomplished at all hazards. No one can say that it was thereby intended that the desired end result be reached by confiscation of substantive security rights of creditors. To the extent that such an intent or effect is attributed by counsel to §77 important constitutional questions are presented which not only prevent such construction but which preclude such a result.

4. Appellants' contended construction presents reasonable and serious doubts as to constitutionality.

It is a basic rule that statutes must be construed not only to prevent unconstitutional results, but also results presenting reasonable doubts as to constitutionality. *Knights Templar, etc., Co. vs. Jarman,* 187 U. S. 197, 205; *Carey vs. South Dakota,* 250 U. S. 118, 122; *Harriman vs. I. C. C.,* 211 U. S. 407, 422; *Fed. Tr. Com. vs. Am. Tobacco Co.,* 264 U. S. 298, 307.

We contend that if and to the extent that it might be assumed that §77 provided or by implication effected an abrogation of the set-off right, the act would be unconstitutional. Immediately, we submit that the contended construction would at least present reasonable doubts as to constitutionality; and that alone precludes the adoption of such construction. The next succeeding discussion will present our claims as to unconstitutionality, and, of necessity, our contentions as to constitutional doubts. To avoid repetition, we therefore proceed to the next phase of our argument.

C. If §77 Be Construed as Providing Abrogation of the Set-Off Right It Is Violative of the Fifth Amendment.

From the argument heretofore set forth we believe that §77 cannot properly be construed as abrogating the set-off right. If the court reaches that conclusion, Question 1 must be answered in the affirmative and without qualification. If a contrary construction be adopted, we nevertheless submit that the answer to Question 1 must still be in the unqualified affirmative for the reasons now to be considered.

In *Louisville Joint Stock Land Bank vs. Radford*, 295 U. S. 555, it was recognized and held that the bankruptcy power of Congress is subject to the Fifth Amendment. The court therein further held that provisions of the Frazier-Lemke Act, which substantially impaired the substantive lien rights of a mortgagee, were, for that reason, violative of the Fifth Amendment and not sustainable as permissive bankruptcy legislation. The court pointed out that prior to the statute there involved

> "No bankruptcy act had undertaken to modify in the interest of either the debtor or other creditors any substantive right of the holder of a mortgage valid under federal law."

And again that

> "the Frazier-Lemke Act is the first instance of an attempt, by a bankruptcy act, to abridge, solely in the interest of the mortgagor, a substantive right of the mortgagee in specific property held as security."

A like conclusion of invalidity of bankruptcy legislation destroying substantive rights seems implicit in the decision in the *Continental Bank case* sustaining the power under §77 to suspend temporarily the remedial enforcement of lien rights. In that case the court said:

> "The injunction here in no way impairs the lien, or disturbs the preferred rank of the pledgees. It does no more than suspend the enforcement of the lien by a sale of the collateral pending further action." * * *
>
> "The injunction here goes no further than to delay the enforcement of the contract." * * * *

And, again:

> "* * * we understand that the injunction may at any time be dissolved upon application and proper no-

tice and showing. It contemplates, as we have already suggested, only reasonable delay."

It may be suggested that the Frazier-Lemke Act expressly limited its application to pre-existing mortgages and that the scope of the decision in the *Radford case* is correspondingly limited. With respect to any such suggestion, we submit:

1. That within such limitations the *Radford* decision would at least require a qualified answer to Question 1, sustaining the set-off right under §77 at least in cases where the right had its origin prior to the enactment of §77.

2. That even a prospective operation of the contended abrogation of the set-off right under §77 would be unconstitutional; hence, an unconditional affirmative answer to Question 1 is still required.

1. *If §77 be construed as abrogating the set-off right, it violates the Fifth Amendment as to such rights accrued before its enactment.*

This is the essence of the *Radford* decision as to the lien rights of a mortgagee. It would seem inescapably applicable as to the possessory lien of the set-off right. If the court should accept appellants' contention as to the implied intent of §77, we submit that, in any event, Question 1 cannot be answered in the negative in so far as it may be attempted to apply that intent to rights of set-off originating prior to the enactment of §77.

We do not intend to offend any rule against excursion outside of the facts here certified. We do feel, however, that we may, with propriety, mention certain facts found by the

court below, as appearing in the reported decision, merely to illustrate the occasion for qualification of any possible negative answer to Question 1.

The deposit account had been maintained "for many years prior to June 7, 1933"—the date of the reorganization petition (11 Fed. Suppl., at 930). The railroad bonds in question had been acquired by the bank upon different dates in 1927, 1928 and 1930 (11 Fed. Suppl., at 931). Section 77 became effective March 3, 1933. Accordingly, the relationship of mutual debtors, as between the railroad and the bank, had originated long before §77 and existed at the time of its enactment. Upon such an hypothesis, permissible under Question 1, that question may involve a decision here as to whether §77, if intended to deny the set-off right, is constitutionally valid in so far as such denial would extend to set-off rights existing at the time of enactment, whether or not the rights had then become enforcible. Under the *Radford* decision, we submit that Congress could not constitutionally destroy such a substantive lien right.

If this court should conclude that §77 impliedly provides for destruction of the set-off right and should further conclude that such provision is valid as to such rights subsequently arising, we still submit that any negative answer to Question 1 would necessarily be qualified, at least, to recognize that such abrogation cannot extend to previously originating and existing set-off rights.

2. *Even a prospective operation of such implied intent to abrogate would be unconstitutional.*

As to a mortgage lien, this contention was advanced, mentioned but not decided in the *Radford case* (294 U. S., at 578, 589).

In the first place, it must be clear that Congress could not constitutionally legislate the set-off right out of existence. It could not decree that the right should never exist or be exercised or judicially recognized. It could not thus encroach upon the powers reserved to the states as to rights arising out of ordinary business or commercial dealings. The set-off right, independent of the Bankruptcy Act, exists and is recognized by the Minnesota courts and by the Eighth Circuit Court of Appeals. *Wallrick vs. Hall,* 19 Minn. 383; *Sweetser vs. Peoples Bank,* 69 Minn. 196; *Habegger vs. First Nat'l Bank,* 94 Minn. 445; *First Nat'l Bank vs. Malone,* 76 Fed. (2d) 251 (8 C. C. A.).

Can Congress, then, under its bankruptcy power, prospectively provide that such a right, thereafter validly arising and existing, shall be denied recognition, and therefore shall be confiscated, in the event of bankruptcy? Could it so provide as to liens subsequently arising under express contract or valid statutes? The absence of authority upon the point is undoubtedly explained by the observations in the *Radford case* that prior to the Frazier-Lemke Act no bankruptcy statutes had ever attempted to impair substantive lien or security rights.

The bankruptcy power is subject to the Fifth Amendment. Destruction of substantive rights, even under the bankruptcy power, is thus forbidden. Since Congress has no power to prevent the creation of lien rights, whether by way of pledge, mortgage, set-off or otherwise, it seems clear that it cannot

provide that bankruptcy proceedings of any type shall operate to destroy such rights validly created—and this, whether the rights are created before or after its enactment attempting so to do. When there is acceptance of the necessary premise that the right is validly in existence when the bankruptcy proceedings are initiated *(ante,* Part I), then its complete rejection in those proceedings is a taking of property even as to such rights arising after such an enactment; and, we submit, a taking without due process. And, we believe, it can be said also that such an enactment would violate the Fifth Amendment in another respect. It is not here contended that §77 contemplates abrogation of other security liens. The *Continental Bank* decision clearly indicates that such liens are preserved in their substantive aspects. The contended construction therefore involves a claim that §77 prospectively abrogated the possessory set-off lien while preserving other liens. We submit that the concept of due process under the Fifth Amendment is broad enough to include the equal protection which the Fourteenth Amendment affords against state legislation (Cf. *U. S. vs. Yount,* 267 Fed. 861, Dist. Pa.). It seems clearly repugnant to fundamental law to say that Congress, in bankruptcy legislation or otherwise, may provide for confiscation of one type of substantive liens while preserving others.

We submit that even as to set-off rights arising subsequent to §77 that act, if construed as providing for their abrogation upon initiation of reorganization proceedings, would be violative of the Fifth Amendment. This, then, would still require an affirmative answer to Question No. 1.

Conclusions as to Question No. 1.

Briefly summarizing, we submit that Question 1 should be unqualifiedly answered in the affirmative because:

1. A proper construction of §77 requires the conclusion that the substantive right of set-off was not thereby abrogated—

   (a) Its application is consistent with the provisions of §77 and it is therefore affirmatively preserved by subdivision (n).

   (b) The contrary claim rests entirely upon conjectural implication from assumed purposes of §77.

   (c) Specific provisions of §77 contemplate preservation of all substantive lien rights.

   (d) The contrary construction presents reasonable doubts as to constitutionality.

2. If §77 were to be construed as intending or providing abrogation of the set-off right, it would, to that extent, violate the Fifth Amendment.

III.

Question 2. If the First Question Be Answered in the Affirmative, Can a Bank Which Owns the Unmatured Bonds of a Railroad Corporation Set Off a Deposit Account of the Railroad With the Bank Against the Bonds, Upon the Filing by the Railroad of a Petition for Reorganization Under Section 77 of the Bankruptcy Act, Alleging That the Railroad Is Unable to Meet Its Debts as They Mature.

Some of the cases indicate that in actions other than those arising out of bankruptcy proceedings a set-off right or lien obtaining as between mutual debtors is not enforcible in such a suit unless the debt has matured, or if not matured, unless insolvency exists. *Scott vs. Armstrong,* 146 U. S. 499; *Schuler vs. Israel,* 120 U. S. 506; *Wunderlich vs. Bank,* 109 Minn. 468; *Storing vs. Bank,* 28 Fed. (2d) 587 (8 C. C. A.).

For reasons next discussed, we submit that neither of these alternative requisites for the enforcement of the right obtain under §68; and if the contrary be held, that either or both of such requisites are within the purview of Question 2.

A. Neither Insolvency Nor Maturity of the Debt Essential to Exercise of the Right Under §68.

1. *Insolvency not essential under §68.*

It should first be noted that *there may be bankruptcy proceedings under the general provisions of the Act, even though there be no insolvency as defined in subdivision 15 of section 1 thereof. George M. West Co. vs. Lea Brothers & Co.,* 174

U. S. 590; *In re Cohn,* 227 Fed. 843 (certiorari denied, *Blumenthal vs. Strat,* 241 U. S. 662); *In re C., R. I. & P. Ry. Co.,* 72 Fed. (2d) 443, 450; *In re Hargadine, etc., Co.,* 239 Fed. 155 (Dist. Mo.); *In re Dressler, Producing Corp.,* 262 Fed. 257 (2 C. C. A.); 1 *Remington on Bankruptcy* (4th Ed.), §48; 11 U. S. C. A., Sec. 21, note 2—p. 177, note 82—p. 213, note 132—p. 235, and numerous cases cited.

Appellants' statement that this court has never so held (App. Br., p. 27) is in error. *(George M. West Co. vs. Lea Brothers, supra.)* Under the terms of §3 of the Act, and the cases above cited, insolvency is not a prerequisite to involuntary bankruptcy proceedings based upon fraudulent transfer or concealment of assets (subd. a-1), a general assignment for the benefit of creditors (subd. a-5), or an admission of inability to pay debts (subd. a-6, section 3, as amended May 27, 1926). Under no circumstances is insolvency a prerequisite to voluntary proceedings. So, we may have a bankrupt and bankruptcy proceedings even though there be no insolvency within the definition of subdivision 15 of Section 1, or otherwise.

If we turn to §68 of the Bankruptcy Act, we find that it contains no provisions whatsoever, limiting its application to cases where insolvency exists. Its language clearly excludes any such limitation. It provides that

> "in all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor * * * one debt shall be set off against the other."

Upon the assumed affirmative answer to Question 1, section 68 applies to all bankruptcy proceedings, both under the general provisions of the Act and under §77. Therefore, the set-off right exists in proceedings based upon fraudulent transfers, general assignments and confessed inability to

pay debts even when there is no insolvency, as defined in section 1. Perforce, it must exist in proceedings under §77 though there be no insolvency as defined in section 1. Therefore, there is no basis for importing into §68, in its application under §77, any requirement of insolvency in the sense of deficiency of assets as compared to liabilities.

It may be noted that under subdivision a-6 of section 3 of the Act (11 U. S. C. A., §21, as amended May 27, 1926), there may be bankruptcy proceedings if a debtor has

> "admitted in writing his inability to pay his debts and his willingness to be adjudged a bankrupt on that ground."

Such proceedings could be had and the right of set-off under §68 could be exercised therein, regardless of insolvency under section 1. In the second question certified we have a like situation under §77—the carrier's petition declaring in writing its inability to pay its debts and its willingness to subject itself to these new provisions of the Bankruptcy Act. Assuming, as does Question 2, that the set-off right persists under §77, there would seem to be no basis or reason for conditioning its exercise upon insolvency under section 1, when clearly that condition is not required in like circumstances under the general provisions of the Act.

2. *Maturity not essential under §68.*

As noted, subdivision (a) of §68 expressly provides for recognition of set-off "in *all cases* of mutual debts or mutual credits." The sole limitations are stated in subdivision (b), denying it as to a debt "not provable against the estate" and as to claims acquired under circumstances not here material. By necessary inference, especially with the broad scope of subdivision (a), a debt that is provable may be set off.

It is well settled that debts not matured are nevertheless provable.

11 U. S. C. A., §103, note 14, p. 45, and cases cited.

It is equally well settled that under §68, debts not matured may nevertheless be set off.

11 U. S. C. A., §108, note 3, p. 260, and cases cited.

This was early recognized by this court in *Carr vs. Hamilton*, 129 U. S. 252, wherein it is said:

> "principle of set off between mutual debts and credits * * * has always prevailed in our own (bankruptcy laws) * * * and it mattered not whether the debt was due at the time of bankruptcy or not."

In *Germania Savings Bank, etc., vs. Loeb*, 188 Fed. 285 (6 C. C. A.), it is said:

> "The word 'debt,' as used in section 68a includes any debt provable in bankruptcy. * * * And a debt is provable, whether due or not at the time of bankruptcy. Bankr. Act. 1898, §63a (1). *It is thus immaterial to the application of section 68a whether or not the notes were due.*"

In *Re Philip Semmer Glass Co.*, 135 Fed. 77 (2 C. C. A.), after quoting §68 and its application to an unmatured debt, the court said:

> "To determine, therefore, whether the holder of a claim is entitled to the benefit of section 68, it is *necessary only to inquire* whether his claim is one provable in bankruptcy."

See also, *In the Matter of United Sportwear Company, Inc.*, 28 Am. Bkptcy. Rep. (N. S.) 451 (D. C. Mass., 5-20-35), wherein the court, under §77B denied the debtor's petition for a summary order for payment of a bank deposit account upon the bank's objections to summary jurisdiction to deter-

mine its right of set-off. The note claimed to be set off was not due until January 13th though the petition under §77B was filed on January 4, 1935.

The bonds in question, though not matured according to their terms, were undoubtedly provable claims under the general provisions of the Act as contemplated by subdivision (b) of §68. They were equally provable under §77 (see subdivisions b and c-5 of §77 as to allowance and provability of claims).

As heretofore noted, the right or possessory lien of set-off arises when mutuality of debts obtains. The alternative conditions of maturity or non-maturity plus insolvency are merely conditions which, in the absence of bankruptcy proceedings, may be essential pre-requisites to the right to enforce. Section 68 of the Bankruptcy Act does not prescribe such conditions as essential to enforcement in the event of bankruptcy proceedings. This alone requires an affirmative answer to Question 2.

B. If the Alternative Pre-requisites to Its Exercise in Equity Were Here Applicable, Those Requisites Are Embraced Within Question 2 or Its Permissive Assumptions.

1. *There is insolvency within the equity concept; this eliminates any possible requisite of maturity.*

There are two distinct definitions of "insolvency." One is the bankruptcy definition, in substance, of deficiency of assets as against liabilities.

Subd. 15, §1 of Bankruptcy Act (11 U. S. C. A., §1).

By its terms, this is not a definition applicable to all instances where the meaning of insolvency may be collateral-

ly involved in controversies arising by reason of bankruptcy proceedings. By its terms it is simply a statement as to when "a person shall be deemed insolvent within the provisions of this title." In other words, in so far as insolvency of the debtor is the basis for bankruptcy proceedings, subdivision 15 of Section 1 furnishes the test. On the other hand, there is insolvency within the equity concept whenever there is *inability to pay debts as they mature. Intercontinental Rubber Co. vs. B. & M. Ry. Co.,* 245 Fed. 122 (Dist. Mass.); *Fed. Reserve Bank vs. Idaho, etc., Assn.,* 8 Fed. (2d) 922 (9 C. C. A.); *Steele vs. Randall,* 19 Fed. (2d) 40 (8 C. C. A.); *American Can Co. vs. Erie P. Co.,* 171 Fed. 540 (C. C. N. Y.); *Martin vs. Hertz,* 224 Ill. 84; *Madsen vs. Burns Co.,* 108 N. J. Eq. 275.

Appellants note (App. Br., p. 28) that this Court, in the *Continental Bank case,* stated that the phrase "unable to meet its debts as they mature," as used in subdivision (a) of Section 77, "obviously means something less than a condition of 'bankruptcy' or 'insolvency' as those terms are employed" in the Act. But those terms are clearly used in subdivision (a) of §77 merely as specifying the alternative circumstances under which proceedings may be had under §77, just as "insolvent" is defined in subdivision 15 of §1 as a basis for proceedings under the general provisions, in those instances where insolvency is required. In neither subdivision of these sections is there any attempt to define insolvency as a pre-requisite to the exercise of the set-off right. It may be noted that Judge Nordbye, below, said:

> "The type of insolvency that will accelerate the maturity of an unmatured debt does not necessarily mean the application of the bankruptcy definition of insolvency." (11 Fed. Suppl., at 936.)

Inability to pay debts as they mature constitutes the equity concept of insolvency. Question 2 assuming such insolvency, the question of non-maturity is immaterial upon any theory.

2. *The bonds must be treated as matured; this eliminates any possible requisite of insolvency.*

If it should be held (contrary to the preceding contentions) that the exercise of the set-off right in bankruptcy proceedings is conditioned, in the alternative, upon insolvency or maturity, and further that insolvency within the equity concept is insufficient, still, if the bonds were matured, or to be treated as matured, the right to exercise the set-off lien still would obtain.

It should be borne in mind that a bankruptcy court acts, so far as may be proper, as an equity court. *Gilbert's Collier on Bankruptcy* (2nd Ed.), Sec. 2, p. 28; Section 2, Bankruptcy Act (11 U. S. C. A., §11); Cf. *Continental Ill. Nat. Bank & Tr. Co. vs. C., R. I. & P. Ry. Co.,* 294 U. S. 648, 676.

And, likewise, the action below was tried as an equity cause and the decree below recognized, established and confirmed the right of set-off and provided for delivery by the bank to the trustee of an equivalent amount of bonds (11 Fed. Suppl., at 932-3). That court properly dealt with set-off as an equitable issue *(ibid.,* pp. 933-7). Question 2 permits the hypothesis of facts found below, though not specifically embraced in the question. If such facts would require at least a qualified affirmative answer to the question, it seems to us proper to note them for that reason.

In its opinion the trial court said:

"It is significant to note that the railway company's petition avers that within a month from the time that

the petition was filed, the company would be faced with maturing interest considerably in excess of $2,000,000, which it could not pay, and, in addition, it would be faced with maturing bonds in a sum exceeding $140,000.00 in the spring of 1934, which it could not pay, and further stated that it was without funds to pay and discharge the aforesaid obligations and alleged that it had no means of borrowing or securing funds. The entire bond issue maturing April 1, 1934, excepting certain payments of interest, is in default and was in default when this action was commenced."

The bonds in question were bonds of said issue. A verified declaration of its utter inability to pay these bonds as they matured, either out of its own assets or out of borrowings, was the very basis upon which the carrier invoked the provisions of §77 and placed itself thereunder. Furthermore, while that petition was filed June 7, 1933, the instant case was not commenced until June 13, 1934. The bonds in question matured according to their terms on April 1, 1934, and have ever since remained in default. Under such facts which are within the permissive assumptions of Question 2, we contend that a court of equity, dealing with an equitable right strongly favored, should treat the bonds as matured in so far, if at all, as that might be deemed necessary for the protection or exercise of the right:

a. The declared inability to pay, which brought the carrier under §77, should be regarded as in the nature of an anticipatory breach, sufficiently maturing the bonds for all questions of mutual rights arising under §77.

b. The actual maturity and default prior to suit and trial permitted and required the court to deal with the situation then presented.

(a) *The bonds should be treated as matured as of the date of the filing of the petition.*

A positive declaration of inability to perform constitutes an anticipatory repudiation of a contract amounting to a total breach. *Restatement of Law of Contracts,* §318; *Matteson vs. U. S. & Canada Land Co.,* 103 Minn. 407.

And likewise, a placing of one's self in a position wherein he cannot perform constitutes such a breach. *Roehm vs. Horst,* 178 U. S. 1; 2 *Remington on Bankruptcy* (3rd Ed.), §812.

When the carrier placed itself under §77, it placed itself in a position disabling itself, of its own volition at least, from paying the bonds as they matured according to their terms. And again, in *Central Trust Co. vs. Chicago Auditorium Ass'n,* 240 U. S. 581, this court said that bankruptcy

> "proceedings, whether voluntary or involuntary, resulting in an adjudication of bankruptcy, are the equivalent of an anticipatory breach of an executory agreement."

We believe that the filing of the petition itself constituted an anticipatory breach. Whether or not every technical concept of anticipatory breach pre-requisite to a suit at law existed, it seems to us clear that these facts would constitute a sufficient basis for equity to treat them as a sufficient breach to mature the debt for equitable purposes. It is hardly thinkable that a debtor can invoke his own declared inability to pay a given debt to secure the protective benefit of a court of equity and still insist that the debt's formal non-maturity will preclude the equity court from treating the debt as thus matured if necessary to protect a creditor's equitable right.

(b) *Their actual maturity and default at the time of suit and trial below would require recognition of the set-off right.*

Question 2 does not embrace a statement of these facts. Nevertheless they are within the assumptions permissible thereunder. They do appear in the record below and in the findings and opinion of the trial court. If, without them, this court should deem a negative answer indicated as to that question, we still submit that a qualified answer would be required which would sustain the set-off right upon such an hypothesis.

The Bankruptcy Court itself is a court of equity. The court below acted as a court of equity. It was dealing with a right originating in equity and favorably regarded. The power and duty of an equity court to do equity is not limited to the precise situation obtaining when a suit is commenced; it may deal with the situation as presented at the time of trial. 10 *R. C. L.*, "Equity," §344, p. 559; 21 *C. J.* 663 (§846); *Randel vs. Brown*, 2 How. (U. S.) 406; *Colby vs. Street*, 168 Minn. 57; *Pond vs. Harwood*, 139 N. Y. 111; *Huffey vs. Lynch*, 143 N. Y. 241; *Bauer vs. Internat'l, etc., Co.*, 201 Mass. 197; *Breckenridge vs. Carey*, 195 App. Div. 156.

Indeed, a court of equity will go so far as to reinstate a set-off or similar right otherwise lost by ignorance or inadvertence. *Union Nat'l Bank vs. McKey*, 102 Fed. 662 (7 C. C. A.), as to set-off right. Semble: *In re Swift*, 111 Fed. 503 (Dist. Mass.); *Standard Oil Co. vs. Hawkins*, 74 Fed. 395 (7 C. C. A.).

Here, the existence of the deposit account and the bank's ownership of the bonds mutually concurred at the time of the filing of the petition. Under the decision in *North Chi-*

cago Rolling Mill Co. vs. St. Louis Ore & Steel Co., 152 U. S. 596, and the principles there applied *(ante,* Part I), the set-off right was thus in existence when the petition was filed. Even if it were held herein that the filing of the petition in no way accelerated the maturity of the bonds, the permissive hypothesis under Question 2 of maturity and default prior to both the commencement and trial of the trustees' suit would require any equity court, dealing with such an equitable right, to act with regard to the situation thus presented. With the right to exercise set-off then fully matured, that right must be sustained.

Question 2 asks whether the right can be exercised by the bank "upon" the filing of the petition. It may be suggested that the foregoing discussion as to subsequent judicial recognition of the right upon its assertion in the trustees' suit is not within the range of the question. It seems to us that "upon" does not mean "concurrently with." Of necessity, it must mean "after and by reason of," and the question must involve the right of a court to recognize and give effect to the right so asserted.

Certain contentions of appellants.

It is dogmatically asserted that the equities are against the bank and in favor of the trustees (App. Br., p. 24), and hence there should be no relaxing of rules in dealing with the set-off. Under the principles heretofore discussed, no relaxing of rules is involved in the decision below nor in an affirmative answer to Questions 1 and 2. In any event, the equities were as the court below declared. Equity clearly demands preservation rather than confiscation of a substantive right. The maxim that "equality is equity" does not contemplate reducing secured creditors to the ranks of the

unsecured; and it would seem implicit therein that the set-off lien cannot be destroyed when other liens are concededly preserved.

It is asserted that there is no reported case in which a set-off right has been asserted in an equity receivership of a carrier (App. Br., p. 30). Without determining the accuracy of the statement we observe that the right was recognized and enforced in an equity receivership, in *Central Appalachian Co. vs. Buchanan,* 90 Fed. 454 (6 C. C. A.). And we might answer in like tenor, that there is no reported case in which the right of set-off has been denied, in an equity receivership of a carrier. The statistics cited do not establish that such rights have not been asserted and allowed as a matter of course.

It is asserted that a holding that the filing of a petition under §77 accelerates all maturities would prevent successful reorganization (App. Br., pp. 28-30). Subdivisions (a) and (e) of §77 sufficiently answer this suggestion.

We have assumed, as have appellants, that Question 2 is not intended to involve any issue as to mutuality. That issue was separately argued and decided below. Lest there be any doubt about its possible involvement in Question 2 we cite, without discussion, the decisions upholding the view that the sole requisite of mutuality exists when *A* owes *B* and *B* owes *A*, though the debts arise out of disconnected transactions. *Libby vs. Hopkins,* 104 U. S. 303; *Scott vs. Armstrong,* 146 U. S. 499; *Chicago Rolling Mill Co. vs. St. Louis, etc., Co.,* 152 U. S. 596; *Bank vs. Malone,* 76 Fed. (2d) 251 (8 C. C. A.); *Bank vs. Bridewell,* 74 Fed. (2d) 331 (8 C. C. A.). See opinion below, 11 Fed. Suppl. at 936.

We submit that Question 2 should be answered in the affirmative.

IV.

Question 3.

A. This Question as to Whether the Right Should Be Recognized and Established in a Plenary Action by the Trustees in Another District Should Be Answered in the Affirmative.

Question 3, in one sense, seems to assume the jurisdiction of the Minnesota District Court to entertain the suit by the trustees upon the debt represented by the deposit account. If such jurisdiction is presupposed, it would necessarily carry with it the jurisdiction to determine all controversies with respect thereto, including the set-off right. A negative answer to the question would therefore seem necessarily to deny one of the assumptions implicit in the question. This will be later discussed herein. We shall first discuss the question as if no such assumption was involved.

1. The Applicable Statutes and Decisions Require an Affirmative Answer to a Like Question Concerning a Like Action by Trustees Appointed Under the General Provisions of the Bankruptcy Act.

Before attempting to determine what new concepts as to jurisdiction are provided or implicit in §77, it seems important to note carefully the extent of, and limitations upon the jurisdiction of the bankruptcy court under the general provisions of the Bankruptcy Act.

(a) *Jurisdiction under general provisions is administrative, exercisable by summary proceedings, and extended and confined to the debtor and his property within the actual or constructive possession of the court.*

The jurisdiction specially conferred upon bankruptcy courts is administrative. Sections 2, 23a, of Bankruptcy Act (11 U. S. C. A., §§11, 46); *U. S. Fid. & Guaranty Co. vs. Bray,* 225 U. S. 205, 217-8; *Babbitt vs. Dutcher,* 216 U. S. 102, 109.

The jurisdiction of the bankruptcy courts is exercisable only by summary proceedings. *U. S. Fid. & Guaranty Co. vs. Bray,* 225 U. S. 205, *supra;* see also authorities next hereinafter cited.

The basis of such jurisdiction is the actual or constructive possession of the debtor's property. *Isaacs vs. Hobbs,* 282 U. S. 734, 737; *Ex parte Baldwin,* 291 U. S. 610, 615; *Gross vs. Irving Trust Co.,* 289 U. S. 342, 344; *Board of Trade vs. Johnson,* 264 U. S. 1, 11; 5 *Remington on Bankruptcy* (3rd Ed.), §2350, p. 410.

Without such possession the bankruptcy court lacks jurisdiction even as to property within its territorial limits. *Harrison vs. Chamberlin,* 271 U. S. 191, 193; *Galbraith vs. Vallely,* 256 U. S. 46, 50; *Jaquith vs. Rowley,* 188 U. S. 620, 625; *In re Uittenbogard,* 295 Fed. 778 (8 C. C. A.).

(b) *In exercising its administrative or summary jurisdiction, it cannot issue process either in rem or in personam beyond its territorial limits; it must resort to ancillary administration.*

This limitation necessarily follows from the context of Section 2 of the Act which confers the power of bankruptcy administration upon the District Courts

"within their respective territorial limits."

Therefore, the bankruptcy court cannot issue valid process outside its territorial limits; and to extend administration to other districts, resort must be had to ancillary receiverships. (Subd. 20 of §2, Bkptcy. Act, 11 U. S. C. A., §11.)

In *Babbitt vs. Dutcher,* 216 U. S. 102, this court said:

"Proceedings ancillary to and in aid of the proceedings in bankruptcy may be necessary in other districts where the principal court cannot exercise jurisdiction."

In *Acme Harvester Co. vs. Beekman,* 222 U. S. 300, it is said:

"The necessary deduction from these cases is to deny to the district courts jurisdiction such as was sought to be asserted in this case by the issuing of an injunction against one not a party to the proceeding, and which undertook to have effect in the distant jurisdiction outside the territorial jurisdiction of the district court."

Cases expressly recognizing and applying the rule that the bankruptcy court cannot issue valid process either *in rem* or *in personam,* outside its jurisdiction, include the following: *Babbitt vs. Dutcher, supra; Acme Harvester Co. vs. Beekman, supra; Noll vs. Hodgson,* 70 Fed. (2d) 19 (4

C. C. A.); *In re Geller*, 216 Fed. 558 (D. C. N. J.); 5 *Remington on Bankruptcy* (3rd Ed.), §2205, p. 297; Cf. *Robertson vs. Railroad Labor Board*, 268 U. S. 619.

When resort has been had to ancillary administration the scope of that jurisdiction is no greater than the jurisdiction of the primary court. 5 *Remington on Bankruptcy* (3rd Ed.), §2213, p. 312; *De Friece vs. Bryant*, 232 Fed. 233 (D. C. Ky.); *West vs. Empire Life Ins. Co.*, 242 Fed. 605 (D. C. Wash.); *In re Mill Iron Constr. Co.*, 56 Fed. (2d) 248 (D. C. N. Y.).

(c) *Bankruptcy court has no jurisdiction over controversies between trustee and third parties as to debts owed or property adversely possessed and claimed by third parties (with exceptions here immaterial); such controversies must be determined in plenary actions by trustees, in other courts.* (Bankruptcy Act, §23.)

As heretofore noted, the administrative jurisdiction exercisable by summary proceedings finds its sole basis in actual or constructive possession of the debtor's property. As to property adversely possessed and claimed by third parties, or debts owed by third parties, that essential basis of such jurisdiction is lacking. It therefore follows that no such jurisdiction obtains as to such controversies; and that they are to be determined only in plenary actions. 5 *Remington on Bankruptcy* (3rd Ed.), §2134, p. 217; §2350, p. 410, and numerous cases there cited; *Harris vs. First Nat'l Bank*, 216 U. S. 382; see authorities, *ante*.

The bankruptcy court itself has no jurisdiction as to plenary actions (with immaterial exceptions hereinafter noted). Jurisdiction as to such actions is expressly vested

in other courts. These conclusions necessarily follow from Section 23 of the Bankruptcy Act (11 U. S. C. A., §46), and the cases so hold.

That section provides as follows:

> "(a) The United States district courts shall have jurisdiction of all controversies at law and in equity, as distinguished from proceedings in bankruptcy, between trustees as such and adverse claimants concerning the property acquired or claimed by the trustees, in the same manner and to the same extent only as though bankruptcy proceedings had not been instituted and such controversies had been between the bankrupts and such adverse claimants.
>
> (b) Suits by the trustee shall only be brought or prosecuted in the courts where the bankrupt whose estate is being administered by such trustee, might have brought or prosecuted them if proceedings in bankruptcy had not been instituted, unless by consent of the proposed defendant, except suits for the recovery of property under section 96, subdivision b, of this title; section 107, subdivision e, of this title; and section 110, subdivision e, of this title."

The exceptions in the concluding portion of subdivision (b), held to create a limited and concurrent plenary jurisdiction in the bankruptcy court concerning actions to avoid preferences and fraudulent transfers, were added by the 1903 and 1910 amendments. These exceptions, not here material, constitute the only instances in which the bankruptcy court itself has plenary jurisdiction. *Bardes vs. Bank,* 178 U. S. 524; *First Nat'l Bank vs. Chicago Title & Trust Co.,* 198 U. S. 280; 5 *Remington on Bankruptcy* (3rd Ed.); §2135, p. 225; §2183, p. 263; §2187, pp. 266-7; §2189, p. 270.

In *Bardes vs. Bank,* 178 U. S. 524, this court said:

> "On the contrary, Congress, by the second clause of §23 of the present Bankrupt Act, appears to this court to have clearly manifested its intention that controversies, not strictly or properly part of the proceedings in bankruptcy, but independent suits brought by the trustee in bankruptcy to assert a title to money or property as assets of the bankruptcy against strangers to those proceedings, should not come within the jurisdiction of the District Courts of the United States, 'unless by consent of the proposed defendant,' of which there is no pretense in this case."

In *First National Bank vs. Chicago Title & Trust Company,* 198 U. S. 280, this court said:

> "The distinction between steps in bankruptcy proceedings proper and controversies arising out of the settlement of the estates of bankrupts is recognized in §§23, 24 and 25 of the present Act. * * * This distinction existed under the prior bankruptcy law, and the then decisions in respect of a proceeding in bankruptcy and an independent suit are applicable. It was settled that the bankruptcy court was without jurisdiction to determine adverse claims to property, not in the possession of the assignee in bankruptcy, by summary proceedings, whether absolute title or only a lien was asserted * * *
>
> "The present Act was plainly framed in recognition of the principle of these cases."

Within this rule, debtors of the bankrupt are adverse claimants against whom proceedings must be had by plenary action: 5 *Remington on Bankruptcy* (3rd Ed.), §2170, p. 251; §2193, p. 276; *In re Roman,* 23 Fed. (2d) 556 (2 C. C.

A.); *In re Howe Mfg. Co.*, 193 Fed. 524 (D. C. Ky.), particularly when the defendant is a bank asserting a right of set-off. *First Nat'l Bank vs. Hopkins*, 199 Fed. 873 (5 C. C. A.); *In re Radley Steel Constr. Co.*, 212 Fed. 462 (D. C. N. Y.); *In re Boston-Cerrillos Mines Corp.*, 206 Fed. 794, 796 (D. C. N. M.).

> (d) *Accordingly, jurisdiction as to plenary actions by trustees against debtors asserting a set-off right is vested not in the bankruptcy court but in the other courts specified in §23, which have jurisdiction therein to recognize the set-off right and to do so though the set-off claim has not been proved in the bankruptcy court.*

This rule has long been established and followed: *Cumberland Glass Mfg. Co. vs. DeWitt*, 237 U. S. 447, 457; *In re Radley Steel Constr. Co.*, 212 Fed. 462 (D. C. N. Y.); *Citizens Bank vs. Lineberger*, 45 Fed. (2d) 522 (4 C. C. A.); *McDaniel Nat'l Bank vs. Bridwell*, 65 Fed. (2d) 428 (8 C. C. A.); *In re Petrich*, 43 Fed. (2d) 435 (D. C. Calif.); *Norfolk, etc., Ry. Co. vs. Graham*, 145 Fed. 809 (4 C. C. A.); *In re Havens*, 182 Fed. 367 (D. C. N. Y.); *Morgan vs. Wordell*, 178 Mass. 350 (Op. by Justice Holmes); *Wasey vs. Whitcomb*, 167 Mich. 58; *Meighan vs. Cohen*, 161 Minn. 302; *Gill vs. Bank*, 195 S. W. 538 (Mo. App.); *Smith vs. Hale*, 56 S. Dak. 12; *Wagner v. Burnham*, 224 Pa. 586; *Steinhardt vs. Bank*, 120 App. Div. 255, 105 N. Y. S. 23; *Moore vs. Joseph*, 40 S. W. (2d) 948 (Tex. Civ. App.); 4 *Remington on Bankruptcy* (4th Ed.), §1473, p. 249; §1460, p. 231.

In the following authorities above cited it is stated that it may be so asserted though not proved in the bankruptcy

court: *Morgan vs. Wordell, In re Havens, Steinhardt vs. Bank, Moore vs. Joseph, Norfolk, etc., Ry. Co. vs. Graham,* and 4 *Remington on Bankruptcy,* §1460, p. 231.

Appellants have erroneously construed *the Cumberland Glass case* (App. Br., pp. 31-5). In the excerpts quoted, the court merely recognized the power of the bankruptcy court to deal with the set-off right "when its action was invoked for that purpose." There is no doubt that a debtor-creditor of the bankrupt may voluntarily submit the claim to that court. The holding of the court was that a defense that former composition proceedings in bankruptcy had involved a right to set-off of the claim now asserted by plaintiff was not a valid defense, because the right of set-off had not been invoked in the bankruptcy proceedings. The court noted with apparent approval, decisions holding that the set-off could be asserted and sustained in a plenary action by the trustee, 236 U. S. 457-8.

In re Radley Construction Co., 212 Fed. 462, it is said:

> "The test of the right to set off such claims, or as the validity of the debts represented thereby, cannot be determined in a summary manner upon motion, and *a claim by the bank that it holds money on deposit for the purpose of application to the payment of another obligation,* the validity of which can only be determined in some suit against the bank, *must be disposed of in an action in a court having plenary jurisdiction,* unless the bank comes into the bankruptcy court to prove some claim involving the amount of these payments." (Italics ours.)

In *Morgan vs. Wordell,* 178 Mass. 350, Justice Holmes, sustaining such right in a plenary action, said:

> "* * * it follows that, although the defendant's claim could not have been proved against the estate, still it is a mutual credit and may be set-off when he is sued."

Under none of these cases was it ever held or intimated that it was essential to such recognition of the set-off right that it should have been "ordered, authorized, approved or consented to" by the bankruptcy court; the contrary is implicit in all these decisions.

Appellants have quoted from *Isaacs vs. Hobbs,* 282 U. S. 734 (App. Br., pp. 36-7). Neither the decision nor opinion therein conflict with any of the rules heretofore set forth. That case, in its essence, merely illustrates the principle of the administrative jurisdiction of the bankruptcy court as to tangible property actually reduced to the possession of the bankruptcy trustee. It was held that in a foreclosure suit in another district, an answer by the trustee asserting his possession and an outstanding order for sale by the bankruptcy court sufficed to prevent the other court from proceeding with the foreclosure. The language in this opinion, and in many others, as to the bankruptcy court's "exclusive jurisdiction over the debtor's property" is necessarily limited to situations wherein the required basis of such jurisdiction exists, namely, actual or constructive possession of the debtor's property. Under the rules heretofore mentioned, *the concept of such "exclusive jurisdiction" has never been extended to controversies involving either property adversely possessed and claimed by third parties or debts owing the bankrupt against which a set-off right is claimed.*

2. WHATEVER ENLARGED JURISDICTION IS DEEMED CONFERRED BY §77, THE PROVISIONS THEREOF SHOULD NOT BE CONSTRUED AS PREVENTING RECOGNITION OF SET-OFF IN A PLENARY ACTION PROPERLY INSTITUTED BY A TRUSTEE IN ANOTHER COURT.

This question should be considered and here answered upon the basis of §77 as originally enacted and in force at the time of the suit and judgment below. The statute as so enacted is set forth as an appendix to appellants' brief, pages 39-56. As so enacted the only express provisions as to jurisdiction were the following:

The clause in subdivision (a) that upon the approval of the petition,

> "the court in which such order approving the petition is entered shall, during the pendency of the proceedings under this section and for the purposes thereof, have exclusive jurisdiction of the debtor and its property wherever located."

Subdivision (n) as follows:

> "In proceedings under this section and consistent with the provisions thereof, the jurisdiction and powers of the court, the duties of the debtor and the rights and liabilities of creditors, and of all persons with respect to the debtor and his property, shall be the same as if a voluntary petition for adjudication had been filed and a decree of adjudication had been entered on the day when the debtor's petition was filed."

By an amendment adopted August 27, 1935, further provisions were added immediately following the above quoted clause in subdivision (a), as follows:

> "* * * and shall have and may exercise in addition to the powers conferred by this section all the powers, not inconsistent with this section, which a Federal court would have had if it had appointed a receiver in equity of the property of the debtor for any purpose. Process of the court shall extend to and be valid when served in any judicial district. The Supreme Court of the United States shall promulgate rules relating to the service of process outside of the district in which the proceeding is pending, and any other rules which it may deem advisable in order to aid district courts and circuit courts of appeal in exercising the jurisdiction herein conferred upon them."

Whether these additions may affect the final answer to Question 3, as literally stated, need not be immediately discussed. They should not produce an adverse answer to Question 3 as applicable to the case at bar because they were not in effect at the time of the suit or judgment below. The judgment below, recognizing the set-off in this case, was entered June 17, 1935 (11 Fed. Suppl. 929). Clearly, Question 3 should be deemed to relate to §77 as it was in force at the time of entry of the judgment below, which is clearly within the contemplation of that question. We shall first consider Question 3 under §77 as originally enacted and in force during the period here material, later discussing whether the 1935 amendments would call for any different conclusion as applied to proceedings subsequent to those amendments.

It seems obvious that §77 contemplates some jurisdiction in the bankruptcy-reorganization court in addition to that possessed under the general provisions of the Bankruptcy Act. The pertinent question is the extent of the additional jurisdiction so contemplated or provided.

(a) *Cogent reasons sustain construction of §77 as extending administrative jurisdiction exercisable by summary proceedings beyond territorial limits of the court, dispensing with the necessity for ancillary administration.*

The only authoritative views as to the enlarged jurisdiction under §77 are those expressed by this Court in the *Continental Bank case.* That decision sustained the power of the bankruptcy-reorganization court to issue orders, effective beyond its territorial limits, temporarily staying foreclosure by pledgees of collateral held by them. Persistence of limitations upon the jurisdiction are implicit in the opinion, as follows:

(a-1) The power was sustained primarily as an exercise of the administrative power existing under §2 of the Bankruptcy Act (294 U. S., at 675, 676, 678) extended beyond the territorial limits by subdivision (a) of §77 *(ibid.,* at 682-3).

(a-2) It was recognized that the power was invoked in a summary proceeding *(ibid.,* at 681, 682) to protect the debtor's property, i. e., its equity in the collateral *(ibid.,* at 681, 683).

(a-3) It was recognized that §77 evidenced "a manifest policy of avoiding ancillary administration as far as possible" *(ibid.,* at 684).

The reasons supporting these conclusions as to intended extension of jurisdiction are found in the opinion and need not here be reviewed. It may suffice to say that the conclusions are in accord with appropriate rules of construction. They evince no radical departure from established policy. They lead to no substantial infringement upon the rights of third parties.

(b) *Cogent reasons preclude construction of §77 as creating plenary jurisdiction to adjudicate controversies with third parties as to debts owed or property adversely and claimed.*

At the outset, it should be noted that the practical reasons for extending the summary jurisdiction beyond territorial limits so as to dispense with ancillary administration do not support any view in favor of creating a plenary jurisdiction not existing under the general provisions of the Bankruptcy Act. Ancillary administration involves cumbersomeness, makes for delay and involves much greater expense, all avoided by dispensing with such administration.

But the investing of the court with plenary jurisdiction to adjudicate controversies with third parties would not accomplish like ends. It would tend to produce some contrary results. Carriers may have hundreds, if not thousands, of controversies with third parties, not within the scope of the administrative or summary jurisdiction of a bankruptcy court, including claims for demurrage, undercharges and others incident to the operation of its business. Such claims may exist against shippers or consignees throughout the country. It is hardly conceivable that Congress intended the unfairness which would be incident to a requirement that such parties should come to the bankruptcy-reorganization court to assert and litigate their defenses to such claims. And any such view would tend to swamp such courts with a multitude of separate actions, resulting in congested calendars and substantial delay in dealing with the more vital problems of actual administration and reorganization. Practical considerations, therefore, suggest no purpose or reason for construing §77 as departing from the long-established policy of bankruptcy legislation which has con-

sistently withheld from the bankruptcy court jurisdiction as to plenary actions involving controversies with third parties. Such considerations, as well as established rules of construction, indicate that no such new concept of jurisdiction was intended.

Authorities previously cited and discussed herein establish that no such jurisdiction exists under the general provisions of the act. Section 77 does not expressly provide for such new jurisdiction. No construction affecting a radical departure from long recognized principles of legislative policy should be indulged. *Robertson vs. Railroad Board,* 268 U. S. 619; *Panama R. R. Co. vs. Johnson,* 264 U. S. 375; *Daniel vs. Guaranty Trust Co.,* 285 U. S. 154, 162.

Furthermore, subdivision (n) of §77 expressly provides, *inter alia*, that

> "in proceedings under this section and consistent with the provisions thereof, *the jurisdiction and powers of the court * * * shall be the same*" (Italics ours.)

as under the general provisions of the Bankruptcy Act. In the *Continental Bank* case, this court, while recognizing that to the extent that subdivision (a) of §77 invested the court with exclusive jurisdiction as to the debtor and its property wherever located, the summary jurisdiction was extended beyond the territorial limits, clearly held that the application of Clause 15 of Section 2 of the Bankruptcy Act persisted under §77. By the same token, and particularly under the express provision in subdivision (n), "the jurisdiction and powers of the court" are still affected by Section 23 of the Bankruptcy Act denying to the bankruptcy court (with immaterial exceptions), and vesting in other courts, plenary jurisdiction in controversies between trustees and third parties.

The reference in subdivision (a) of §77 to jurisdiction of

the debtor and "its property wherever located" serves only to extend the summary jurisdiction territorially. It does not create a plenary jurisdiction not theretofore existing. We have noted that under the general provisions vesting exclusive jurisdiction over the debtor and his property within the territorial limits, the term "his property" as applied to assets subject to a lien, means only the debtor's equity; and that such jurisdiction does not extend to a determination in plenary actions of controverted issues with a lienor or with a third party asserting a set-off right. In the *Continental Bank* case, this Court attributed to the term "its property" as found in subdivision (a) the same limited meaning. Speaking of the collateral, the Court said:

> "That the equity which the debtor retained was a property interest was not and could not be disputed."

And again:

> "The equity in the collateral remaining in the railroad company is property; and over this, whenever located, the federal district court is given exclusive jurisdiction by the precise language of §77" (i. e., subd. a).

The power to enjoin a sale was sustained as a necessary incident of the right to protect that equity.

In re Prudence Bonds Corporation, 75 Fed. (2d) 262 (2 C. C. A.), involved the validity of an order of a bankruptcy court under §77B restraining an accounting suit in state court by a holder of the debtor's bonds, secured by pledged collateral. After noting provisions in §77B, similar to those just cited in subdivisions (a) and (n) of §77, the court said:

> "It is clear both from the language used in these subdivisions, and from the consequences of a contrary ruling, that Congress did not intend the bankruptcy court in proceedings under section 77B to take over all litigation between the debtor and third persons."

In the Matter of United Sportwear Company, Inc., 28 Am. Bankruptcy Reports (N. S.) 451 (D. C. Mass., May 20, 1935), a debtor under §77B petitioned for a summary order directing payment by a bank of the amount of a deposit account. The bank, holding the debtor's note for a like amount, had set off the same against the deposit account. The court said:

> "The bank has objected to the jurisdiction of the court to act summarily and claims it is not subject to a plenary suit in this court without its consent. The objection to jurisdiction and to venue are well and seasonably taken and debtor's petition must be denied."

Like conclusions under like provisions of §77 seem clearly required. There is no basis for any view that §77 newly creates in the bankruptcy-reorganization court any plenary jurisdiction, exclusive or concurrent, to adjudicate controversies between trustees and third parties as to property adversely possessed and claimed or as to choses in action against which a set-off right is asserted.

Such jurisdiction has never before been granted to a bankruptcy court. No provision of §77 purports to create it. No basis for implying it exists. Practical considerations, established rules of construction and the express provisions of subdivision (n) compel the conclusion that jurisdiction as to such controversies and actions remains as before. Accordingly, the Minnesota District Court had jurisdiction to entertain the trustees' suit upon the deposit account and to recognize and establish therein the set-off right.

(c) *Even if §77 were properly to be construed as vesting such plenary jurisdiction in the bankruptcy court, the latter may consent to exercise of jurisdiction by other courts; and here, such consent should be assumed from the trustees invoking the jurisdiction of the Minnesota District Court.*

Even as to matters concerning which the bankruptcy court is invested with exclusive jurisdiction, that court may consent to litigation by the trustee in other courts. *Ex parte Baldwin,* 291 U. S. 608, 619; Cf. *In re Missouri, etc., Service Co.,* 11 Fed. Suppl. 434 (D. C. Mo.); *In re Sentinel Oil Co.,* 12 Fed. Suppl. 294 (D. C. Calif.).

Question 3 as certified indicates that the trustees appointed by the bankruptcy court in Illinois voluntarily instituted this action in the District Court of Minnesota. It would seem that it should be assumed that in so doing they were acting properly and not unlawfully. This would necessitate the assumption of consent of the court appointing them if that should be deemed a requisite of their right to institute the action.

Certainly, the trustees should not here be heard to deny the very jurisdiction they have voluntarily invoked. It is true that consent cannot create a jurisdiction otherwise lacking. But clearly the trustees cannot here insist that the Minnesota District Court has jurisdiction to award them a judgment for recovery upon the deposit account but is without jurisdiction to allow the set-off right. If any jurisdiction exists in the Minnesota court in the action assumed in the question, it includes the jurisdiction to determine the whole controversy.

The 1935 amendments to §77.

We have heretofore noted that the judgment of the District Court below was rendered June 17, 1935, prior to the amendments to §77 adopted August 27, 1935. Question 3 in its relation back to Questions 1 and 2 deals with §77—not with §77 as amended. It should be so construed because of the fact above noted. If this Court should deem the question to relate to §77 as amended and should reach a negative answer based upon such amendments, the answer should clearly so indicate. The Circuit Court of Appeals must base its ultimate decision upon the effect of §77 without the amendments, and care should be had to avoid confusion or misunderstanding which might result from a negative answer based upon the amendments.

In so far as Question 3 is concerned, we further submit that the amendments should not produce a negative answer. The clause conferring the powers of a federal court in an equity receivership add nothing upon this issue. A federal equity court had no jurisdiction to determine set-off in a summary proceeding; the right is determinable in a plenary action by a receiver. *McDaniel vs. Bridwell*, 65 Fed. (2d) 428, *ante*. The provision that process may extend to other districts is not an investiture of additional jurisdiction. It is clearly in aid only of the summary jurisdiction otherwise granted or existing. The same must be true as to the provisions for promulgation of rules by this Court as to such service.

We submit that §77 has not provided, expressly or by implication, for departure from the long established policy and rule that plenary jurisdiction over controversies between trustees and third parties, relating to property adversely possessed and claimed and to choses in action against which

a set-off right is claimed, is vested in those courts which would have jurisdiction in like actions between the bankrupt and the third party. That being so, it is wholly immaterial that the set-off right, long held cognizable by such other courts, has not been "ordered, authorized, approved or consented to" by the bankruptcy court. In passing it may be noted that Question 3 does not assume any order of the bankruptcy court forbidding the institution of such a suit by the trustee in another court nor any order of the bankruptcy court purporting to forbid, or stay, the exercise of the set-off right. In any event, under the authorities heretofore discussed, that court has no jurisdiction to forbid or stay the exercise of that right. Such an edict, if effective in a suit by the trustee, would totally destroy the right. Jurisdiction to determine the right (except by consent) does not rest with the bankruptcy court. It never has; and under §77 it remains in other courts as above noted.

B. Any Negative Answer to Question 3 Can Only Be Based Upon Total Absence of Jurisdiction of the Minnesota Court, Requiring Dismissal of the Trustees' Suit Below Without Recovery and With Preservation of the Set-Off Right for Adjudication by the Illinois Court.

We have submitted that Question 3 should be answered in the affirmative. However, if this Court should reach a contrary conclusion, the situation presented would seem to make it appropriate that the consequences of a negative answer be clearly indicated.

Any negative answer must, of necessity, be based upon a view that §77 vests plenary jurisdiction exclusively in the

bankruptcy court. Of necessity, that would mean that the District Court of Minnesota had no jurisdiction to entertain the trustees' suit. That, in turn, would mean that all proceedings below are a nullity. Any stated incapacity of the Minnesota Court to recognize and establish the set-off right (existing under the assumed affirmative answers to Questions 1 and 2) would follow, if at all, from the total lack of jurisdiction of that court to entertain the plenary action. If that conclusion be reached, we submit that the attainment of a proper result below would require an answer indicating the basis therefor and that the required result would be a dismissal of the trustees' suit below. Allowance of recovery by the trustees below, free from the set-off, would destroy the very right assumed in Question 3 as existing. Only by dismissal of the trustees' present action could that right be preserved for adjudication by the Illinois Court, if it should be concluded herein that it is the sole forum for adjudication or establishment of the set-off right.

CONCLUSION.

We submit that each of the three certified questions should be answered unqualifiedly in the affirmative. We also submit that if any contrary conclusions should be reached concerning Questions 1 and 3 as stated, the answers should be qualified as herein suggested in the discussion of those questions.

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Respectfully submitted,

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